

Request for City Council Committee Action

Date May 18, 2001

To Transportation & Public Works Committee

Referral to Ways & Means/Budget Committee

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Approved by David Sonnenberg

Patrick P. Born Kathleen O'Brien

Subject Recommended financial workout plan to improve the financial condition of

the Equipment Services Fund

Presenters in Committee Tammy Omdal, Financial Services and Budget Director David Sonnenberg, Director, Public Works

Recommendation

The following short-term and long-term financial strategies are recommended to resolve the deficits within the Equipment Services Fund (further detail on each recommendation is provided in an attached report):

- 1. Convert existing variable rate debt to fixed rate and structure long to allow for a debt service structure that fits within estimated cash flows (as previously adopted by the Council in December).
 - No additional Council action needed in 2001.
- 2. Identify annual funding level and financing method for annual equipment/fleet purchases.
 - Approve resolution (in separate Council action) to request the Board of Estimate and Taxation to issue an additional \$2.0 million in bonds for a total of \$6.0 million in 2001.

- 3. Transfer available General Fund reserves (potential annual reserves in excess of the 10 percent General Fund requirement) to the Equipment Services Fund.
 - Approve the transfer of \$5.2 million of cash from the General Fund to the Equipment Services Fund in year 2001.
- 4. Commit to raising annual revenue needed to cover the full cost of providing equipment services.
 - No additional Council action needed in 2001, budget already included \$1.0 million in additional funding.
 - In 2002, \$2.0 million in additional funding (above base adjustments)
 will be needed (see Table Seven for more information).

Financial Impact (Check those that apply) No financial impact (If checked, go directly to Background/Supporting Information)
_X Action requires an appropriation increase to the Capital Budget Action requires an appropriation increase to the Operating Budget _X Action provides increased revenue for appropriation increase Action requires use of contingency or reserves
Other financial impact (Explain): Approval of the financial workout plan will have future year revenue and expenditure implication.
Request provided to the Budget Office when provided to the Committee Coordinator

Background/Supporting Information

Attached you will find a report that provides a financial workout plan for the Equipment Services Fund, one of the six internal service funds of the City

The financial workout plan has been developed in response to Mayor and City Council direction to develop a financial strategy to address both the annual operating deficit and the accumulated cash deficits for the Equipment Services Fund.

The plan provides financial strategies to address the deficits within the fund. The Public Works Department has prepared a summary (included in this report) of the productivity changes that have been implemented and realized so far as was recommended in the 1997 Equipment Services Study, prepared by an external consultant.

We look forward to presenting this information to the Mayor and City Council.

Equipment Services Fund Report on Financial Workout Plan May 2001

Summary of Recommendation

The City of Minneapolis is faced with a financial challenge with respect to the internal service funds of the City. The City remains financially sound because it deals with financial challenges in a deliberate and timely manner. The purpose of this report is to propose to the Mayor and City Council a recommended financial workout plan for the Equipment Services Fund (ESF). The ESF is one of six internal service funds.

The ESF has been operating at a deficit, as a result the year-end cash deficit for this fund as of December 31, 2000 was \$16.7 million. This report provides some background information on the ESF and then presents financial recommendations to eliminate annual spending deficits by 2002 and the cumulative cash deficit by 2006.

The following financial strategies are recommended to resolve the deficits within the ESF (further detail on each recommendation is provided at the end of this report):

- 1. Refund existing outstanding variable rate debt (as previously adopted by the Council in December) to allow for a debt service structure that fits within estimated cash flows.
- 2. Identify annual funding level and financing method for annual equipment/fleet purchases.
- 3. Transfer available General Fund reserves (potential annual reserves in excess of the 10 percent General Fund requirement) to the Equipment Services Fund.
- 4. Commit to raising annual revenue needed to cover the full cost of providing equipment services.

Financial Background

The ESF is used to account for the City's Radio Shop Division and Equipment Services Division. The Equipment Services Division of the Public Works Department comprises almost 87% of total expenditures within this fund.

Internal service funds, including the ESF, are intended to operate like businesses. These funds account for the sale of goods and services among City departments. Departments that "provide" the service are to charge the cost of providing such goods and services to the "user" departments. For several years, the City has not set the internal service funds rates high enough, resulting in annual and cumulative deficits in these funds, including the ESF.

The ESF does not have sufficient revenue to cover expenditures, neither operating nor non-operating expenditures (i.e., debt service payments) as shown below.

Table One (in thousands of dollars)

	1997 Year Ending	1998 Year Ending	1999 Year Ending	2000 Year Ending (un- audited)
Total Revenue	\$20,073	\$24,086	\$25,578	\$28,932
Total				\$33,237
Expenditures	\$22,556	\$29,172	\$29,971	
Net Loss	\$(2,483)	\$(5,086)	\$(4,393)	\$(4,305)

As a result of the annual operating deficits shown above, the ESF has accumulated a cash deficit. Below is a summary of the changing cash position of the fund.

Table Two (in thousands of dollars)

	1997 Year Ending	1998 Year Ending	1999 Year Ending	2000 Year Ending (un- audited)
Beg Cash				\$(15,708)
Balance	\$(2,109)	\$(4,836)	\$(11,156)	
Change	\$(2,727)	\$(6,320)	\$(4,552)	\$(984)
Ending Cash Balance	\$(4,836)	\$(11,156)	\$(15,708)	(\$16,692)

Over the last five years, the City of Minneapolis has made significant investments in the ESD, including upgrades and replacement to the fleet (\$23.3 million) and construction of new facilities (\$22.5 million) to replace the aging facilities. These investments were meant to position the ESD to operate more cost effectively. However, departments

purchasing services from the ESD did not have sufficient funding to pay for the full costs associated with these additional investments and purchases.

As a result, beginning in 1999, fleet replacement was scaled back from the recommended \$7 million annual replacement level to \$3 to \$4 million annually to help prevent a further decline in the cash position of the fund. This was intended to be a short-term strategy until a permanent funding strategy was identified.

In recent years, the City has shown a commitment to resolve the deficit position within the internal service funds, including the ESF. Over the last two years, a total of \$4.0 million in additional funding has been added to the budget to address the internal service funds' deficits. Of this amount, \$2.0 million was dedicated for the ESF. This additional funding was an important and significant step toward resolving the financial condition in the internal service funds. However, as previously indicated to the Mayor and City Council, more revenue will be required in addition to any potential cost savings measures (which have not been identified at this time).

Public Works Summary of the 1997 Equipment Services Fleet Study

This section was prepared by the Public Works Department to summarize the events from the initial Equipment Services Division Study in 1997 to the current proposed workout plan.

The 1997 Equipment Services Study (prepared by the consultant, DMG/Maximus) provided a strategy to position the Equipment Services Division to be "a service and cost competitive fleet operation."

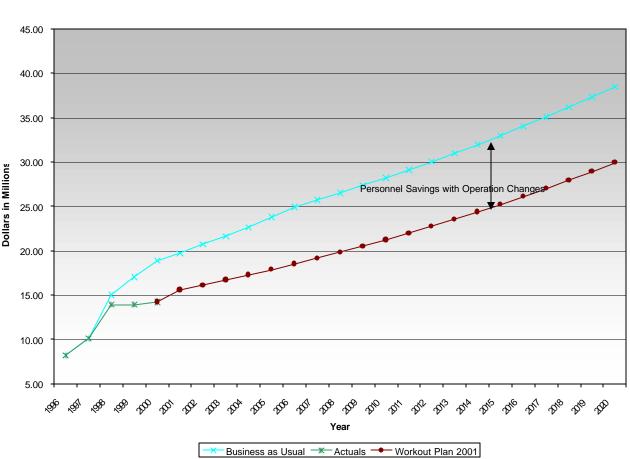
The base philosophy of the plan was to reallocate part of the dollars spent on maintenance to more timely renewal of the fleet. The study analyzed costs to keep each class of equipment on the street, and determined that the City's overall costs would be lower if equipment was replaced within its useful life.

The study recommended an immediate acceleration in equipment replacement followed by a reduction in equipment shop staffing. The staffing could be reduced because less maintenance would be required for a fleet within its useful life. The City would use the labor savings to pay for the bonds used to purchase the renewed fleet. Once most of the fleet was within its useful life, the staff savings would be shifted to pay-as-you-go equipment purchasing.

The original plan was to reduce personnel by 41 FTE's, including the consolidation of the Water Division equipment operations. As of the 2001 budget, a net decrease of 26 FTE's have been made. As of the 2001 budget, the Public Works Department is behind schedule on equipment purchases due to unanticipated funding shortfalls and the compounding negative cash position of the fund.

During the past several years there have been policy decisions made that increased the fleet size, moved drivers and operators into the Equipment Division, and extended the hours of staffing of several ward shops. In addition, new facilities have been completed; the debt service on the bonds issued to finance the facilities is an additional expense to the fund.

To address these changed conditions, in May 1999, the City engaged the consultant who completed the 1997 study, DMG/Maximus, to update the plan. The next chart depicts the anticipated personnel expense savings between "business as usual" (the cost of operating the Equipment Division without operational changes), the actual costs, and the workout plan.



Equipment Services Division Personnel Expenses

As it can be seen in the previous chart, the ESD has had cost savings by reducing staff, but without the equipment renewal plan outlined in this document, additional staff will eventually be needed to maintain the aging fleet. Public Works recognizes that there will be additional productivity savings accomplished by fully implementing the consultants' study recommendations. See the next table for a current (as of February 2001) update on the implementation of these recommendations.

Table Three

Fleet Study Recommendations - Update Equipment Services Division As of February, 2001

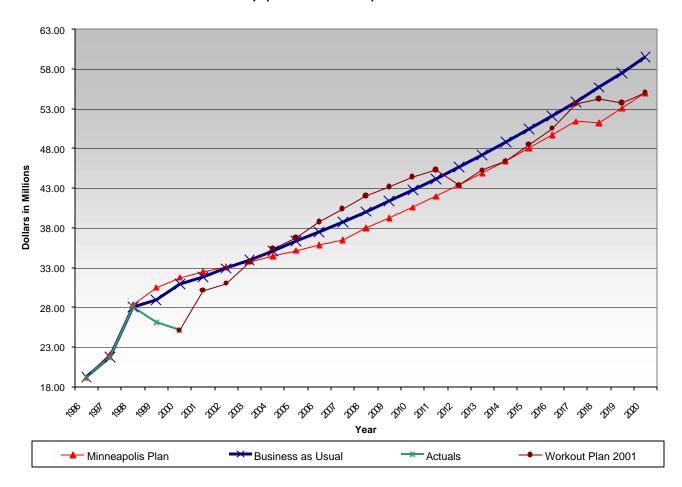
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	Recommend- ations	% Implement- ation as of Feb. 2001	Impact on Shop Product- ivity	Anticipated Completion Date	Remarks
1	Renew the fleet	20%	Medium	>2012	With the increase of fleet size and the reduction of funding for fleet replacement, the percentage of the fleet within its useful life has slipped to 52%. Once the fleet has been renewed, productivity gains will allow for the reduction of several shop positions.
2	Construct new shop	100%	Significant	2000	Shop operations started to move into the Currie Facility in February 2000. Consolidation of fleet operations into the Facility will be completed by the end of May 2001.
3	Downsize the fleet	100%	Medium		The fleet size goal of 1,716 pieces of equipment was reached in 1998. Since that time, customer needs and special requests have increased the fleet size to 1,771 as of December 2000.
	Implement Management Information System	75%	Some	Dec. 2001	Staff is working with the City's Finance Department to finalize interfaces for parts, fixed asset management and data exchanges.
5	Establish a balanced Internal Service Fund (revenue to cover expenditures)	10%	Some		New finance plan will resolve revenue issues and fully fund equipment operations.
6	Adopt a Preventative Maintenance focus	15%	Some	2003	As the fleet becomes renewed the Equipment Services Division (ESD) will be able to focus on preventative maintenance tasks and less on the repairing/rebuilding of equipment.
7	Strategic use of vendors	80%	Medium	Ongoing	As ESD moves towards a preventative maintenance focus more vendors will be utilized for non-preventative maintenance repairs.
8	Reorganize ESD	70%	Medium	2002	Ongoing - Redefining of positions to be completed in 2001. Implementation of the final plan will begin in 2002.

Table Three (Continued)

	Recommend- ations	% Implement- ation as of Feb. 2001	Impact on Shop Product- ivity	Anticipated Completion Date	Remarks
9	Develop policies and procedures	70%	Some	2002	Policies and Procedures are being firmed up. June 2002 is the completion date for consolidating this information.
10	Develop performance- based specifications	70%	Some	Ongoing	ESD has adopted the MN/DOT and Hennepin County performance based specifications for 70% of ESD purchases.
11	Implement life cycle cost vehicle selection	10%	Some	Ongoing	Ongoing – Implementation of the management information system will provide tracking of vehicle costs to help manage the fleet.
12	Restructure parts operations	60%	Some	2001	Related to recommendation numbers 2, 4, 7 and 8. Consolidation of purchase orders in process, potential savings in bulk ordering and invoice processing.
13	Consolidate operations at Currie Facility	75%	Some	2001	Opened Final Phase of the Currie Facility in Nov-2000. The Snelling shops will move to the Currie Facility in May 2001, completing the consolidation. The net decrease in Equipment Division positions, since 1996, is 26.0 FTE's or \$1.2 million reduction in annual personnel expenses.
14	Consolidate fuel operations	100%	Some	2000	Completed.

The next chart shows the expense plan for the Equipment Service portion of the ESF. As is shown, the "Minneapolis Plan" had cost savings as compared to "Business As Usual". The "Workout Plan" will increase spending over the next ten years above the "Business As Usual" amount in order to get back to the "Minneapolis Plan" spending level. The original recommendation, although delayed, will still be realized.

Equipment Services Expense Plan



Recommended Financial Workout Plan for Equipment Services Fund

Attachment A of this report provides a financial forecast plan for the ESF. The schedule provides forecasted revenue and expenditures and the corresponding impact of cash balance for the ESF for years 2000 through 2012.

Based on the recommendations and financial assumptions that are outlined on the next several pages, the fund will begin to generate an annual surplus beginning in 2002. However, it is projected that it will take a minimum of five years to eliminate the accumulated cash deficit, assuming the financial assumptions are realized. As renewal of the equipment fleet is achieved, as evident by the fleet being within normal life cycles for the equipment, Public Works will evaluate possible further reduction in shop positions (see Table Three, Item One). To the extent further reductions are achieved, the return of a positive financial position will be accelerated.

Recommendations:

The Public Works and the Finance Department recommend that the Mayor and City Council approve the financial work-out plan proposal, as provided in points one through four below, and in the attached financial plan (Attachment A).

The Mayor and City Council will be informed of the financial progress of this plan as part of the on-going financial reporting process, in addition to the annual budget process.

1. Convert existing outstanding variable rate debt to fixed rate and structure long to allow for a debt service schedule that fits within estimated cash flows (as previously adopted by the Council in December).

In December 2000, the City Council approved refunding of the outstanding variable rate bonds issued to finance construction of equipment services facilities and fleet replacement. Below is a summary of the principal and estimated interest payments associated with the projected debt service schedule. The debt service payments will be structured based on projected cash flows for the ESF. Due to cash flow constraints, principal payments will be deferred resulting in higher than normal interest payments over the life of the bonds.

Table Four

Forecasted Debt Service for Fixed Rate Facility and Equipment							
Replacement Bonds							
Years	Principal	Estimated Interest	Total				
2001 to 2021	\$20,450,000	\$17,283,154	\$37,733,154				

2. Identify annual funding level and financing method for future equipment/fleet purchases.

<u>2001 Capital Expenditures</u>. The 2001 adopted budget includes \$4.0 million in approved capital spending and \$2.0 million that was "reserved" until approval of a workout plan. The source of funding for the \$6.0 million in equipment fleet purchases will be bond proceeds under this workout plan.

<u>Future Capital Expenditures</u>. Annual capital expenditures for equipment/fleet replacement will be as follows:

Table Five
Annual Capital Expenditures -- Fleet Replacement

	Equipment/Fleet Spending	
Year	(in millions)	Source of Funds
2001	\$6.0	Bonds
2002	\$6.1	Bonds
2003	\$6.2	Bonds
2004	\$6.3	Bonds
2005	\$6.4	Bonds
2006	\$7.0	Bonds
2007	\$7.1	Bonds
2008	\$7.2	Bonds
Subtotal	\$52.3	Bonds
2008	\$7.4	Cash
2009	\$7.6	Cash
2010	\$7.8	Cash
2012	\$8.1	Cash
Subtotal	\$30.9	Cash
Total	\$83.2	

<u>Projected Bonds Outstanding - Fleet Replacement</u>. Table six below provides a summary of projected debt service associated with issuing additional bonds from years 2001 through 2008 for equipment fleet replacement. The debt service payments will be structured based on projected cash flows for the ESF.

Table Six

Forecasted Debt Service for Equipment Fleet Bonds								
Years Principal Estimated Interest Total								
2001 to 2018 \$52,300,000 \$18,528,000 \$70,828,00								

3. Transfer available General Fund reserves (potential annual reserves in excess of the 10 percent General Fund requirement) to the Equipment Services Fund.

The 2001 adopted budget anticipates a \$5.2 million transfer of cash from the General Fund to the ESF. The \$5.2 million was the amount of available reserves at year-end 1999 above the 10 percent requirement for the General Fund. This transfer of cash is reflected in the financial workout plan for the ESF (as shown in Attachment A). This amount will be transferred in 2001 as part of adoption of this workout plan.

In future years, it is possible that additional cash transfers will be available from the General Fund. However, because of the uncertainty at this time, the workout plan does not anticipate any additional transfers. To the extent that additional cash is available, the timeline for restoring financial stability to the ESF will be accelerated.

4. Commit to raising annual revenue needed to cover the full cost of providing equipment services.

Revenue for the ESF must increase annually to cover "base" expenditure increases within the fund (i.e., wage increases, equipment purchases). To cover these payments to the ESF, there needs to be sufficient General Fund and Enterprise Fund resources available.

In addition to identifying revenue to cover "base" expenditures, revenue must also be made available to eliminate accumulated cash deficits that have resulted from prior year under-funding. The proposed financial plan will require approximately \$7.0 million in additional funding over the next five years, and another \$1.3 million over the remaining five years, from years 2007 to 2012 (see table on next page).

The majority of the funding shown below will need to come from either property tax revenue, cost savings, or additional non-property tax sources that are available for funding general services.

	Table Seven Equipment Services Fund Estimated Annual Revenue Increases									
Year	E	Base Increases	Deficit Coverage ¹	Total ²						
roui	Public Works ³	Fire	Police	Bellok Goverage	· otai					
2002	483,891	1,023,750	1,068,540	-	2,576,181					
2003	708,197	544,225	589,911	790,254	2,632,587					
2004	768,135	555,110	601,709	765,337	2,690,291					
2005	829,473	66,212	113,743	739,897	1,749,325					
2006	892,248	67,536	116,018	713,922	1,789,724					
2007	956,495	68,887	118,338	687,400	1,831,120					
2008	1,022,251	70,264	120,705	160,319	1,373,539					
2009	1,069,554	71,670	123,119	142,669	1,407,012					
2010	1,118,043	73,103	125,582	124,635	1,441,363					
2011	1,167,750	74,565	128,093	106,209	1,476,617					
2012	1,218,708	76,056	130,655	87,383	1,512,802					
Total	10,234,745	2,691,378	3,236,414	4,318,024	20,480,561					

¹ Revenue needed to eliminate cash deficit caused by prior years' expenditures that were in excess of revenue.

² For planning purposes, annual increase above "base budget" is estimated to be \$2.0 million annually. In some years the actual amount of revenue adjustment may be more or less depending on forecasted cash flow needs.

A portion of the "Public Works/Other" base increase will be charged to the City's Enterprise Funds for services

delivered. This is estimated to be between 20-30 percent of the total.

ATTACHMENT A
Equipment Services Fund Financial Plan as of 7/31/01

	1998	1999	2000	2000	2001	2002	2003	2004	2005	2006
	Actual	Actual	Budget	actual	Budget	Forecast	Forecast	Forecast	Forecast	Forecast
Operating Revenues:										
Charges for Sales	1,665,380	2,329,744	2,200,000	3,107,219	3,615,027	3,669,252	3,724,291	3,780,156	3,836,858	3,894,411
Rents Public Works and Other	15,984,655	17,716,442	16,890,265	19,987,607	17,221,023	17,704,914	19,203,364	20,736,836	22,306,206	23,912,376
Rents Police	1,480,341	1,480,341	2,427,234	2,427,234	3,427,000	4,495,540	5,085,451	5,687,160	5,800,903	5,916,921
Rents Fire	1,187,501	1,187,501	1,187,501	1,187,501	1,187,501	2,211,251	2,755,476	3,310,586	3,376,797	3,444,333
Rents Radio Shop	1,797,617	1,941,866	1,750,000	1,832,410	2,108,964	2,151,143	2,194,166	2,238,049	2,282,810	2,328,467
Other	563,293	366,928	601,000	889,710	596,025	602,417	609,032	615,880	622,966	630,301
Total	22,678,787	25,022,822	25,056,000	29,431,682	28,155,540	30,834,518	33,571,781	36,368,666	38,226,541	40,126,809
Operating Expenditures:										
Operations	22,643,799	22,965,403	24,284,346	24,163,956	24,956,318	25,663,754	26,393,491	27,146,272	27,922,867	28,724,071
Equipment (Tools & Radio)	791,130	424,231	567,100	164,137	611,500	620,673	629,983	639,432	649,024	658,759
Equipment (Fleet)	6,832,512	4,780,337	4,443,733	2,878,092	6,000,000	6,100,000	6,200,000	6,300,000	6,400,000	7,000,000
Total	30,267,441	28,169,970	29,295,179	27,206,185	31,567,818	32,384,427	33,223,474	34,085,705	34,971,891	36,382,830
Net Operating Gain/(Loss)	(7,588,654)	(3,147,148)	(4,239,179)	2,225,497	(3,412,278)	(1,549,909)	348,307	2,282,961	3,254,650	3,743,979
Non-Operating Revenues/(Expenditures):										
Net Other Non-Operating Expenditures	(13,453)	(1,402,812)	(2,213,234)	(4,466,503)	(995,500)	(1,157,695)	(1,128,706)	(864,557)	(894,274)	(924,882)
Bond Proceeds) O	0	0	0	6,000,000	6,100,000	6,200,000	6,300,000	6,400,000	7,000,000
Debt Servce Work out Bonds	0	0	0	0	(127,500)	(452,500)	(2,260,000)	(2,997,500)	(3,715,000)	(4,425,000)
Workout Tsf from Genl Fund	0	0	0	0	5.200.000	0	0	0	0	0
Debt Service (Bond Facilities & Equip)	(333,396)	(507,232)	(1,006,500)	(818,990)	(1,173,955)	(1,075,625)	(1,201,375)	(1,361,600)	(1,194,600)	(1,103,975)
Debt Service (Bond 800Mzh)	0	0	0	0	0	0	(57,010)	(350,000)	(350,000)	(350,000)
Total	(346,849)	(1,910,044)	(3,219,734)	(5,285,493)	8,903,045	3,414,180	1,552,909	726,343	246,126	196,143
Net Change in Cash	(7,935,503)	(5,057,192)	(7,458,913)	(3,059,996)	5,490,767	1,864,271	1,901,216	3,009,304	3,500,776	3,940,122
Adjustments for Retained Earnings:										
Depreciation	(3,923,110)	(4,120,458)	(3,900,000)	(4,170,452)	(4,560,822)	(4,992,792)	(5,360,230)	(5,676,070)	(5,950,661)	(6,292,281)
Purchases	6,773,111	4,784,728	4,557,153	2,925,370	6,122,300	6,720,673	6,829,983	6,939,432	7,049,024	7,658,759
Total	2,850,001	664,270	657,153	(1,245,081)	1,561,478	1,727,881	1,469,753	1,263,362	1,098,363	1,366,478
Net Change in Retained Earnings	(5,085,502)	(4,392,922)	(6,801,760)	(4,305,077)	7,052,245	3,592,152	3,370,969	4,272,666	4,599,139	5,306,600
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Retained Earnings:										
Beginning Balance	7,545,502	2,460,000	(1,932,923)	(1,932,923)	(6,238,000)	814,246	4,406,397	7,777,366	12,050,032	16,649,172
Ending Balance	2,460,000	(1,932,923)	(8,734,683)	(6,238,000)	814,246	4,406,397	7,777,366	12,050,032	16,649,172	21,955,772
Cash:										
Beginning Cash	(4,840,000)	(11,159,996)	(15,708,411)	(15,708,411)	(16,692,157)	(11,201,390)	(9,337,119)	(7,435,903)	(4,426,599)	(925,822)
Ending Cash	(11,159,996)	(15,708,411)	(21,755,297)	(16,692,157)	(11,201,390)	(9,337,119)	(7,435,903)	(4,426,599)	(925,822)	3,014,299